

Tilburg University

Challenging neighbours

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Published in:
CPB Report

Publication date:
1997

[Link to publication in Tilburg University Research Portal](#)

Citation for published version (APA):
Bovenberg, A. L. (1997). Challenging neighbours. *CPB Report*, 1997/2, 3-3.

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Challenging Neighbours

Economic policy has become more focused on structural issues rather than traditional macroeconomic policies. In response to this shift in emphasis in policymaking, CPB is increasingly exploring how economic institutions affect economic performance. In 1992, CPB published the study "Scanning the Future," which contained various long-term scenarios about institutional developments. In September of this year, CPB will present another study dealing with economic institutions entitled "Challenging Neighbours: Rethinking German and Dutch economic institutions."

What does this study offer? First, it provides an analytical framework for analyzing economic institutions. The framework starts from four main market failures and four coordination mechanisms that help to alleviate these market failures.

These coordination mechanisms (the four C's) are competition, control, cooperative exchange, and common values and norms. An analysis of the strengths and weaknesses of the various coordination mechanisms gives rise to four fundamental trade-offs, namely flexibility versus commitment, incentives versus solidarity, diversity versus scale, and experimentation versus certainty.

The economic performance of a country depends on its position on these trade-offs together with social, technological, and economic conditions characterizing its environment. Changes in these conditions, e.g. brought about by trends, affect the trade-offs and hence performance. Maintaining a satisfactory economic performance in the face of such changes thus requires adjustments in economic institutions. Some trends, such as globalization, individualization, and the increased heterogeneity of the population, increase the importance of the strengths of the competitive coordination mechanism, including flexibility, diversity, experimentation, and incentives. Other trends, however, such as increased vulnerability of low-income groups, increase the importance of commitment and solidarity enforced through cooperative exchange or control. Indeed, the challenge is to find new mixes of the various coordination mechanisms in response to changing conditions.

This process of social innovation involves learning by trial and error and trading off various imperfections. Various countries respond in different ways to new challenges. This diversity offers scope for mutual learning and experimenting. The main purpose of "Challenging Neighbours" is to learn by comparing the institutional orders of Germany and the Netherlands. In some cases, the study is broadened by including the US and the UK as benchmark countries.

The second contribution of "Challenging Neighbours" involves policy options for the Netherlands and Germany based on the analysis of institutions in various fields. German unification has put a lot of strain on economic developments in Germany. Some ten years before German unification, the Dutch economy experienced a deep crisis, which had resulted from inadequate responses to the stagflation and the oil crises of the seventies. Around 1982, the need for reforms had become obvious, and the Netherlands embarked on a long, painful, and gradually unfolding, process of structural adjustment. By now, in spite of the different tracks followed during the last 15 years, the Dutch and German economies feature about the same level of GDP per head and about the same relative employment level. At the moment, the Netherlands has gained the momentum of institutional reform. Whereas Germany faces the challenge to get the reform process going, the Netherlands should keep up its process of structural reform. Indeed, the unfinished agenda for both countries is still lengthy and involves, among others, pension and health care reform and preemptive labor market policies aimed at raising labor-market participation (see also the article in this issue entitled 'Dutch employment growth: An analysis').

In any case, the work on structural change is never finished. By exchanging information about country-specific experiences, countries can help each other with the difficult task of reforming institutions in a world that we understand only imperfectly. Following Henk Don's pondering of the Dutch miracle in CPB Report's last issue, this issue contains brief articles on the Irish Renaissance and Wonderful Denmark. Just as the Dutch economy, the small open economies of Ireland and Denmark have been performing quite well in recent years.

For CPB itself, "Challenging Neighbours" involved a learning process of its own. CPB is in the process of putting more emphasis on long-term structural issues, international comparative studies, and economic institutions. Accordingly, the study of the German and Dutch economies is an exercise in institutional economics in search of useful policy options. Several themes deserve further in depth study. In particular, the empirical importance of various trade-offs needs to be explored further.

The Dutch Ministry of Economic Affairs and CPB are co-organizing an international conference in Düsseldorf on the strengths and weaknesses of the German and Dutch economies based on "Challenging Neighbours." You can take part in this stimulating experience (note the registration form on the opposite side). See you there!

Lans Bovenberg

Jeroen van der Meide

Lans Bovenberg, editor in chief of CPB Report, is one of CPB's two deputy directors.

The cut-off date used in the compilation of the projections in ECONOMIC OUTLOOK was end May.